DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0478
Gross Income Tax and Adjusted Gross Income Tax
For the Year 1998-2000

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ISSUES

I. Gross Income Tax--Interstate Commerce

Authority: Ind. Code § 6-2.1-3-3; 45 IAC 1-1-120 (repealed effective January 1, 1999); 45 IAC 1.1-3-3; *Reynolds Metal Co. v. Indiana Dept. of State Revenue*, 433 N.E.2d 1 (Ind. Ct. App. 1982).

Taxpayer protests the imposition of gross income tax with respect to items that Taxpayer retains title to, though the items are stored at the seller's location.

II. Adjusted Gross Income Tax--Unitary filing

Authority: Ind. Code § 6-3-2-2.

Taxpayer protests the disallowance of unitary filing between Taxpayer and a related holding company.

III. Adjusted Gross Income Tax--Deductions

Authority: Ind. Code § 6-3-2-2.

Taxpayer protests the disallowance of a deduction for interest paid by Taxpayer to a related holding company.

IV. Adjusted Gross Income Tax--Net operating losses

Authority: Ind. Code § 6-3-2-2.6; I.R.C. § 382.

Taxpayer protests the disallowance of net operating loss carryforwards after Taxpayer had been acquired by another company.

V. Tax Administration--Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer is a business engaged in making toothpaste tubes, primarily for a large toothpaste manufacturer. With respect to its operations, Taxpayer manufactures its tubes at its plant in another state. When Taxpayer manufactures its tubes, it puts the name of the company on the tubes it sends to the company's Indiana facility. Title to the toothpaste tubes remained with Taxpayer until such time as the tubes were filled by the company; however, as a matter of practice, the tubes were purchased by the company unless the tubes were not in compliance with the manufacturer's standards at the time of shipment. Taxpayer claimed that the sales were the result of interstate commerce; however, upon Department audit, the auditor determined that the taxpayer's sales were conducted in Indiana and thus subject to gross income tax.

In addition, Taxpayer had operated as part of a larger group of companies for several years but filed separate Indiana returns. In mid-1998, Taxpayer and its group were sold to another company. Later in 1998, Taxpayer was sold as a separate entity to yet another company. These sales created a limitation on net operating losses under the Internal Revenue Code. However, upon audit, the Department determined that the net operating losses could not be carried forward after 1998, and accordingly assessed additional tax on this basis.

In 2000, Taxpayer requested Department consent for it and the holding corporation that had acquired Taxpayer in 1998 ("holding company") to file unitary tax returns; however, Taxpayer did not request permission to include its foreign parent. The Department sent a standard letter permitting such filing subject to audit review. Taxpayer and the holding company proceeded to file unitary returns for two of the years in controversy. However, the Department's audit later determined that the two companies should have filed separately. Further, the audit denied a deduction for interest paid by Taxpayer to the holding company.

Finally, with respect to the assessments listed above, the Department assessed a negligence penalty of ten percent. Taxpayer has also protested this assessment.

I. Gross Income Tax—Interstate Commerce

DISCUSSION

Taxpayer's first point of contention is with respect to the imposition of gross income tax on its sales of toothpaste tubes to an Indiana facility. Taxpayer manufactures its tubes at its plant in another state. When Taxpayer manufactures its tubes, it puts the name of the company on the tubes it sends to the company's Indiana facility. Title to the toothpaste tubes remained with Taxpayer until such time as the tubes were filled by the company; however, as a matter of practice, the tubes were purchased by the company unless the tubes were non-compliant at the time of shipment.

Taxpayer argues that its sales really were between its manufacturing plant in another state and the company's Indiana facility. Accordingly, Taxpayer maintains that the sale should be characterized as one in interstate commerce, rather than an Indiana sale occurring at the location where the toothpaste tubes were stored, and accordingly exempt under Ind. Code § 6-2.1-3-3. In support of its contention, taxpayer cites to the case of *Reynolds Metal Co. v. Indiana Dept. of State Revenue*, 433 N.E.2d 1 (Ind. Ct. App. 1982). In that case, an aluminum producer entered into contracts with four distributors for the sale of the producer's products. The producer and distributor had entered into the contracts outside Indiana. As part of the contract, the producer would manufacture its products at an agreed-upon price, and then ship it to the distributors. Payments were made to the producer monthly, based on withdrawals from the distributor's inventory. The distributor assumed any risk of loss, had responsibility for insuring the products, and had responsibility for paying property taxes. The parties could agree to accept the return of non-salable goods, and the producer could demand return of their products if the distributor declared bankruptcy. *Id.* at 16. The Department argued that the relationship was a consignment and thus subject to tax, while the producer argued that the producer had only a security interest, and thus the sale was exempt as being in interstate commerce. The court noted that the relationship between the distributor and the producer more closely resembled a security interest in property rather than a consignment. Accordingly, the transaction between the producer and the distributor was treated as a sale, and thus treated as being in interstate commerce. *Id.* at 18.

Taxpayer argues that its inventory arrangement with the manufacturing plant was in reality a sale prior to the shipment of tubes to the manufacturing plant. Taxpayer has argued that it had limited rights to the inventory after it reached the manufacturing plant. Further, Taxpayer argues that the manufacturer only rejected defective tubes and continued to use older tubes (for instance, a different outer design) that Taxpayer had supplied, giving further evidence that the property in question was really a sale, title notwithstanding.

Here, 45 IAC 1.1-3-3(d)(6) and its pre-1999 counterpart, 45 IAC 1-1-120, is best applicable to this situation. That regulation states that:

> (d) Gross income derived from the sale of tangible personal property in interstate commerce is subject to the gross income tax if the sale is completed in Indiana. The following examples are situations where a sale is completed in Indiana prior to or after shipment in interstate commerce:
> ***
> (6) A sale to an Indiana buyer by a nonresident seller after the goods are transported into Indiana.

Here, the title to the property changed when the manufacturer took the tubes and puts its toothpaste in the tubes. Further, unlike the producer in Reynolds who was treated as having a security interest in the metal, Taxpayer expressly does not have a security interest in the toothpaste tubes pursuant to paragraph 3 of the manufacturer's "Consignment Policy." Thus, the sales took place in Indiana after the tubes were shipped into Indiana. Accordingly, the income in question was Indiana gross income and properly subject to tax.

FINDING

Taxpayer's protest is denied.

II. **<u>Adjusted Gross Income Tax</u>--Unitary filing**

DISCUSSION

Taxpayer also protests the disallowance of unitary filing with a domestic holding company. In particular, Taxpayer notes that the two entities had the same owners and the same management. Further, Taxpayer notes that the holding company had no separate employees, and Taxpayer's staff handled the administrative functions of the domestic holding company.

One or more taxpayers may petition to file a combined (unitary) return if such request is made within thirty (30) days of the end of the taxpayer's taxable year, the companies subject to combined filing must show that the entities' income is such that the income does not fairly reflect income from Indiana sources per Ind. Code § 6-3-2-2(*l*), and that the inability to fairly reflect its Indiana income can be remedied by combined filing. Ind. Code § 6-3-2-2(q) Here, Taxpayer made a timely request for unitary filing with it and the holding company. The Department in turn sent a letter permitting Taxpayer and holding company to file as a unitary filer, subject to Department audit.

Under Ind. Code § 6-3-2-2(*l*):

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> > (1) separate accounting;
> > (2) the exclusion of any one (1) or more of the factors;
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In effect, three criteria must be met under Indiana statutes for unitary filing. First, a taxpayer must show that it is a unitary business. Second, a taxpayer must show that its Indiana income on a separate company basis does not fairly reflect its Indiana source income. Third, the taxpayer must show, under Ind. Code § 6-3-2-2(*l*)(4), that its income can be remedied by unitary filing.

For the sake of this discussion, Taxpayer and its domestic holding company will be assumed to be unitary; however, the Department does not concede that Taxpayer and its domestic holding company were unitary. Unitary status does not automatically permit combined filing. Unitary filing *and* an inability to fairly reflect Indiana income permits unitary filing for Indiana. Ind. Code § 6-3-2-2(p). With respect to the inability to fairly reflect income, the domestic holding company pays financing debt. The domestic holding company is owned by yet another company based in a foreign country, and the domestic holding company must pay interest on the financing debt to the foreign holding company-- a debt that the foreign holding company created for the purpose of the acquisition of Taxpayer. Under Ind. Code § 6-3-2-2(*o*) and (q), it effectively becomes Taxpayer's option to include the foreign company. If Taxpayer, its domestic holding company and the foreign holding company were all included in the unitary return, this would have fairly reflected the overall Indiana income of Taxpayer's operations. However, by permitting Taxpayer the full scope of this deduction, while stating that the foreign company's income was not includible manages to accomplish two things. First, it fails to show that the Taxpayer's income, as determined on a separate company basis, does not fairly reflect Indiana income. Second, it created its own form of not fairly reflecting Indiana income, by allowing a deduction of interest on a debt created by a commonly-owned taxpayer, without the inclusion of the resulting income, diluting the income of the entire unitary entity claimed by Taxpayer.

Taxpayer has further argued that the Department may not rescind its permission to file unitary returns retroactively absent failure by Taxpayer to present material facts. However, the Department in its response to Taxpayer's request for unitary filing explicitly gave its permission to file the returns *subject to Department audit*. Thus, Taxpayer was permitted to file such returns, but the Department could audit the returns and determine whether the unitary filing was improper.

Taxpayer further protests the disallowance of consolidated filing with the same holding company. Taxpayer has conceded this issue, and thus is denied.

FINDING

Taxpayer's protest is denied.

III. Adjusted Gross Income Tax--Deductions

DISCUSSION

Taxpayer has also protested the disallowance of interest paid by it to the foreign holding company. In particular, when Taxpayer was purchased, its domestic holding company borrowed several million dollars from its foreign holding company. Then, after the purchase of Taxpayer was complete, the domestic holding company dropped down to Taxpayer roughly half of the debt that it incurred. The debt in question correlated to debt that was incurred in the first acquisition of Taxpayer and which was transferred from its first acquiring group to Taxpayer.

Ind. Code § 6-3-2-2 generally provides that a corporation's adjusted gross income begins with the corporation's taxable income for federal income tax purposes. Under Ind. Code § 6-3-2-2(*l*), the Department is permitted several powers, including the disallowance of deductions if the deductions result in a corporation's Indiana income not being fairly reflected.

Here, Taxpayer sought to deduct interest that reflected an artifice of Taxpayer's creation-namely, a loan from the foreign holding company to the domestic holding company to purchase Taxpayer. Alternatively, it can be viewed as debt that was incurred as a result of the first acquiring group's acquisition of Taxpayer. Either way, Taxpayer is effectively seeking the benefit of being able to deduct the interest paid by one hand to its other hand, without a resulting inclusion of income. Accordingly, Taxpayer's protest is denied.

FINDING

Taxpayer's protest is denied.

IV. Adjusted Gross Income Tax--Net Operating Losses

DISCUSSION

Taxpayer has also protested the disallowance of its net operating losses for Indiana purposes under Ind. Code § 6-3-2-2.6. In particular, the Department stated that "[t]he corporation did not calculate the section 382 limitation utilizing the value of the old corporation immediately before the first ownership change."

Under I.R.C. § 382, a corporate taxpayer is limited in certain instances in the amount of its net operating losses that it may use in years after an ownership change. In effect, the limitation is the lower of the net operating losses that it may have used prior to the ownership change or the amount as computed under § 382. If a taxpayer goes through multiple ownership changes, the lowest amount computed under § 382(b) is the amount that can be used.

Here, Taxpayer underwent two ownership changes during a short period of time. When it became part of the first acquiring company, a portion of the operating group's net operating losses became subject to a § 382 limitation of roughly $10,000,000 according to the taxpayer. When the second sale of Taxpayer to its current owner occurred, Taxpayer claimed a § 382 limitation of roughly $3,000,000.

The auditor's principal objection was that Taxpayer had not provided sufficient information to substantiate the second § 382 limitation, both in terms of actual carryover after the acquisition by its present owner and by not providing information with respect to two sales of property held by Taxpayer. Accordingly, the auditor interpreted this as meaning that the § 382 limitation was zero. However, Taxpayer has provided sufficient information, both with respect to the election to treat the first § 382 limitation as the amount claimed by Taxpayer and with respect to a subsequent audit of Taxpayer by the IRS, to conclude that the amount of its carryover is correct. However, the effects of such carryover must be determined by further auditreview.

FINDING

Taxpayer's protest is sustained subject to audit review.

V. Tax Administration--Negligence Penalty

DISCUSSION

The Department may impose a ten percent negligence penalty. IC 6-8.1-10-2.1 and 45 IAC 15-11-2. Generally, a deficiency resulting from a Department audit will result in penalty assessment. IC 6-8.1-10-2.1(a)(3). However, the Department may waive this penalty if the taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed…." *Id*.

With respect to the penalty, Taxpayer has not provided sufficient information to permit penalty waiver.

FINDING

Taxpayer's protest is denied.

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